Elbit Systems Ltd.
Edited Conference Call Transcript
March 28, 2023

Operator: Welcome to the conference call to discuss Elbit Systems' results for the fourth quarter of 2022. Thank you all for holding, all participants are at present in a listen-only mode. Following management's formal presentation, instructions will be given for the question-and-answer session. As a reminder, this call is being recorded.

I would now like to turn the call over to Rami Myerson, Elbit Systems' Investor Relations Director. You may begin.

Rami Myerson: Thank you, operator.

Good day everyone, and welcome to our fourth quarter 2022 Earnings Call. On the call with me today are Butzi Machlis, our President and CEO, Kobi Kagan our CFO and Yossi Gaspar, Senior EVP - Business Management.

Before we begin, I would like to point out that the Safe Harbor Statement in the Company's press release issued earlier today also refers to the contents of this conference call.

As we do every quarter, we will provide you with both our regular GAAP financial data as well as certain supplemental non-GAAP information. We believe that this non-GAAP information provides additional detail to help understand the performance of the ongoing business. You can find all the detailed GAAP financial data, as well as the non-GAAP information and the reconciliation, in today's press release.

Kobi will begin by providing a discussion of the financial results, followed by Butzi who will talk about some of the significant events during the quarter and beyond. We will then turn the call over to a question and answer session.

Earlier today, we hosted an investor conference at the Tel Aviv Stock Exchange. A recording of the event is available in the Investor Relations section of our website at www.elbitsystems.com.

Investors and analysts that wish to ask questions related to the topics discussed at the investor conference are welcome to present their questions during the Q&A session of the call.

With that, I would like now to turn the call over to Kobi. Kobi - please?

Kobi Kagan: Thank you Rami. Hello everyone, and thank you for joining us today.

The 2022 annual results reflect a healthy business environment supported by growing defense budgets around the world and another year of significant contract awards. We ended the year with a record order backlog of $15.1 billion up 11% relative to the end of 2021.

Our financial performance in 2022 also includes the impact of supply chain disruptions and labor cost inflation. This included a $62 million expense related to employee stock price linked compensation plans and an additional $10m of retention bonuses. Our GAAP and Non-GAAP results have always included these expenses but this year they were higher than in recent years, following the share price appreciation.

Our budgets and longer-term planning assume that the global economic trends of supply chain and wage inflation headwinds will gradually subside from the second half of 2023.

We continue to invest in R&D to enhance our portfolio and maintain our competitive edge. We invest in sales and marketing to expand our customer base, and also continue to invest in capex to improve and expand our manufacturing footprint.

I would note that the sale of Ashot Ashkelon to FIMI Opportunity Funds was

completed at the end of the second quarter of 2022, and our results in the second half of 2022 do not include a contribution from Ashot Ashkelon.

I will now highlight and discuss some of the key figures and trends in our financial results.

Fourth quarter revenues were one billion, five hundred and six million dollars compared to one billion four hundred and ninety four million dollars in the fourth quarter of 2021. For 2022 as a whole, our revenues were 5.5 billion dollars, versus 5.3 billion dollars last year.

In terms of annual revenue breakdown across our areas of operation. C4ISR at 29% of revenues, increased year-over-year, mainly due to UAS and Anti-Submarine Warfare sales. Airborne Systems accounted for 37% and declined year over year. The growth in training and simulation sales helped offset lower airborne precision guided munition sales. Land Systems was 22% of total revenues and the year over year decline is mainly due to the sale of Ashot Ashkelon. Electro-Optics accounted for 10% and increased year over year due to increased sales of night vision systems. Other sales accounted for 3% and declined year-over-year mainly due to lower sales at our US medical instrumentation subsidiary.

Our diverse geographic revenue base is important to the long-term sustainability of our business. In 2022, North America contributed 27%, Europe 23%, Asia-Pacific 26% and Israel contributed 19% of revenues. European revenues increased mainly due to growth in UAS, munitions and training and simulation sales. North America revenues were lower mainly due to a decline in medical devices sales. Asia-Pacific revenues declined mainly due to lower precision guided munitions and C4I sales.

The non-GAAP gross margin for the fourth quarter was 25.7%, compared to the fourth quarter of 2021 at 25.5%. For the full year of 2022, non-GAAP gross

margin was 25.5% compared with 26.2% last year. GAAP gross margin in the fourth quarter was 25.3% of revenues compared to 25.1% in the fourth quarter of 2021. GAAP gross margin in 2022 was 24.9%, compared with 25.7% in 2021. Gross margins in 2022 reflect an unfavorable program mix, wage inflation and supply chain disruptions. GAAP and Non-GAAP gross profit in 2022 include approximately $35 million of expenses related to stock price linked compensation plans.

The fourth quarter non-GAAP operating income was $103 million or 6.8% of revenues, compared with $120 million or 8.0% of revenues last year. GAAP operating income for the fourth quarter was $120 million, versus $107 million in the fourth quarter of 2021. Non-GAAP operating income in 2022 was $357 million or 6.5% of revenues compared with $451 million or 8.5% of revenues last year. GAAP operating income was $368 million versus $419 million last year. Operating Margins declined year-over-year due to higher R&D and sales and marketing expenses.

The operating expense breakdown in 2022 was as follows: Net R&D expenses were 7.9% of revenues, versus 7.5% in 2021, Marketing and selling expenses were 5.9% of revenues, versus 5.5% last year, G&A expenses were 5.7% of revenues, compared to 5.1% last year.

We have increased investment in Research and Development and in Sales and Marketing to realize the potential opportunities provided by defense budget growth and increased demand for our capabilities.

Other operating income of $68.9 million in 2022 included capital gains related to the sale of buildings in Israel and the UK as well as a facility relocation grant of $28.6m received by a subsidiary in Israel in the fourth quarter.

Operating profit in 2022 include expenses of approximately $62 million related to stock price linked compensation plans.

Financial expenses were $27 million in the fourth quarter, compared to $20 million in 2021. Financial expenses in 2022 were $51 million, compared to $40 million last year and reflect the higher interest rate environment.

Other expenses were $24 million in 2022 and resulted mainly from the revaluation of holdings in affiliated companies and expenses related to non-service costs of pension plans.

We recorded a tax benefit of $5 million in the fourth quarter, compared to a tax expense of $92 million in 2021. Taxes on income in the fourth quarter of 2021 included a one-time expense of approximately $80 million related to the amendment of legislation regarding exempt earnings from approved enterprises in Israel. The effective tax rate in 2022 was 8.2%, compared to 34.3% in 2021 that included the extraordinary expense.

Our Non-GAAP diluted EPS was $1 and 68 cents in the fourth quarter and $6 and 3 cents for the full year of 2022.GAAP diluted EPS was $1 and 91 cents for the fourth quarter of 2022 and $6, and 18 cents for the full year. The stock price linked compensation expenses in 2022 were $1.26 on an EPS basis.

Our backlog of orders as of December 31, 2022 was $15.1 billion, $1.4 billion higher than the backlog at the end of 2021. Approximately 60% of the current backlog is scheduled to be performed during 2023 and 2024, and the rest is scheduled for 2025 and beyond.

Operating cash flow for the fourth quarter was a $195 million dollar inflow compared to a $260 inflow in the same quarter last year. For 2022, we reported a $240 million operating cash inflow versus $417 million in 2021. Cash flow from investing activities includes the higher capex related to the new facilities in Israel and in Charleston, South Carolina as well as the roll out of the ERP system.

The Board of Directors has declared a dividend of 50 cents per share.

I will now turn the call over to Mr. Machlis, Elbit's CEO. Butzi, please go ahead.

Butzi Machlis: Thank you Kobi.

2022 was another good year for Elbit Systems with sustained growth and a record order backlog. We continued the strategic transformation of Elbit Systems, moving up the value chain from a systems provider into a company that provide comprehensive and relevant solutions to its growing global customer base. We initiated this transformation during the previous decade and you have seen the successful implementation as the order book and revenue growth accelerated in recent years. We have also seen a step up in the number of large three digit contract awards.

As part of the broader transformation of Elbit Systems we have invested in an operational transformation to improve performance and our ability to deliver the growing backlog. At our 2023 investor conference, earlier today, we presented some of these investments.

We have increased our investment to upgrade and expand our manufacturing footprint. We have acquired new machines, we are adopting new technologies and implementing processes to increase the throughput and efficiency of our production facilities. For example, we have increased the capacity of our Tel Hai radio production factory in Northern Israel by 60% or 10 thousand additional radios a year.

We are also building new facilities around the world. Construction of our new ammunition production site in Ramat Beka is progressing on schedule and should be up and running from 2024. This new, state of the art facility should benefit from growing demand for munitions. We have invested in new production facilities across Europe, in the UK, Germany and Romania. In 2023,

we plan to open a new Ground Combat Vehicle assembly and integration Center of Excellence in Charleston, South Carolina. In 2021 and 2022 we increased our capex to fund the building of these and other new facilities. We believe this investment will deliver good returns and support growth over the coming years.

We plan to complete the implementation of the new ERP system across the company by the second half of 2023. As a reminder, Elbit Systems is moving from 11 different ERP systems we used in the past to a single ERP system.

We expect the total investment in the new ERP system to be close to $200 million. Approximately two thirds of this investment is the cost of the system, that will be amortized over the coming years. Approximately a third of the investment are the expensed costs related to the implementation, that impacted our profitability in recent years.

We expect the successful implementation of the new ERP systems to support an improvement in profitability and cash generation.

Elbit Systems has also been impacted the global supply chain disruptions in recent years that slowed revenue growth and increased our cost base. To mitigate the impact of these disruptions and maintain timely deliveries to our customers we increased inventories.

Our working assumption is that global supply chain pressures gradually ease over 2023, with a more significant improvement from the second half of 2023.

In 2022 we increased our investment in R&D to sustain development of leading solutions that provide our customers with a valuable competitive advantage. The significant awards we received in 2022 and in recent months have validated the alignment between Elbit Systems' portfolio and our customers' priority areas of defense spending and their mission critical requirements.

The potential for orders from European countries has come up often during investor calls and meetings over the last year, following the announcements on

defense budget increases by most European governments. We described the noticeable increase in customer interest across Europe and told you that we expected this interest to gradually convert into firm orders. In recent months, we announced a series of European contracts across a range of capability areas including artillery and rocket artillery, UAVs, C41 and armored vehicles. We also reported strong growth in European revenues in 2022. We expect this trend to continue over the coming years as European Governments increase defense spending and recapitalize both their military forces and the domestic defense industrial base.

Elbit Systems is well positioned to benefit from these trends following the significant investment made to expand our presence across Europe over the last decade. Our subsidiaries across Europe, from the UK to Romania, employ hundreds of employees, support the local supply chain and are an integral part of the domestic defense industrial base. We have also partnered with most of the large European Defense companies. In 2022, we announced a JV with KMW, the German armored vehicle manufacturer, to cooperate on the the Euro PULS, the next generation of rocket artillery systems for European customers. The $70 million contract we received in January 2023 and the $133 million contract announced in March from European countries highlight both the demand for rocket artillery in Europe and Elbit's leading position in this market.

UAVs is a second capability area where we are benefiting from increased demand. In December 2022, U-TACS, our UK Subsidiary, was awarded a $410 million 5-year framework contract by the Romanian Ministry of Defense for Watchkeeper X Tactical Unmanned Air Systems. In December, we also received a contract from the Australian MOD for our Skylark UAVs.

Elbit Systems is Israel's largest defense contractor and an important part of the Israeli economy. Recent political developments and the judicial legislation

proposed by the government have not impacted our business, until now.

However, sustained political instability has implications for the local defense industry, as we have seen in the past, and could also increase economic uncertainty. I am confident that Israel's leadership will act responsibly to stabilize the situation and ensure Israel's long-term security and prosperity.

In recent months we were awarded significant long-term contracts by the Israeli MoD. In January we received a $180 million contract to provide and operate a new Mission Training Center to train the IAF's F-15 and F-16 Aircrew. In January, we also received a $107 million contract to provide and operate Advanced Armor training centers for the IDF.

Elbit Systems has developed a broad portfolio of market leading training and simulation solutions for militaries around the world. Our training and simulation technological solutions have been selected by a range of customers including the US, UK, Greece and Poland. We believe there is significant potential in this market for our solutions that provide more realistic training that better prepares soldiers for a wide range of scenarios at a lower cost.

And with that, we will be happy to take your questions. Operator?

Operator: Thank you. Ladies and gentlemen, at this time we will begin the question-and-answer session. If you have a question, please press star-one. If you wish to cancel your request, please press star-two. If you are using speaker equipment, kindly lift the handset before pressing the numbers. Your questions will be polled in the order they are received. Please stand by we poll for your questions. The first question is from Ellen Page of Jefferies. Please go ahead.

Ellen Page: Good morning, guys. Thanks for the question.

Rami Myerson: Good morning, Ellen.

Ellen Page: Just looking at Europe, it's like in 2022, obviously, there's a lot of higher defense

spending, but how much of the 11% backlog growth can be attributed to Europe? And is there any way to think about the mix of long cycle versus short cycle demand from the region?

Yossi Gaspar: Hi Ellen, this is Yossi. I'm not sure I got question properly. Could you repeat it, please?

Ellen Page: Sure. So, just looking at European demand, how much of the 11% backlog growth was from Europe? And can you talk about the mix of long cycle versus short cycle orders in Europe?

Yossi Gaspar: Well, I would say a significant part of our backlog growth did come from Europe. However, Asia Pacific and the US were also a very nice growth of the backlog. We do not provide the exact breakdown. But you are right that Europe is a significant contributor to that. From the point of view of the spread of the backlog, we do indicate how much of our backlog is going to be transformed in revenues in the ’23 and ’24 period, and the rest of that during ’25 and onwards. Usually it stands at about 60%, roughly, of our backlog, and this percentage did not change a lot over the years. It’s quite stable.

Ellen Page: Okay, helpful. And just on Land systems, it's been pretty lumpy through 2022. What drove the weakness in the quarter? And how do we think about that business into 2023?

Butzi Machlis: It's Butzi. Hi. I just want to remind us that Ashot's numbers were deducted from Land revenues from the second quarter of 2022. We see growing demand for our Land solutions, in Europe as well as in other places. So, I'm quite optimistic that the growth related to land systems will continue in the near future.

Ellen Page: Thank you. I'll hop back in the queue.

Rami Myerson: Thanks, Ellen.

Operator: The next question is from Pete Skibitski of Alembic Global. Please go ahead.

Pete Skibitski: Hi, good afternoon, everyone.

Rami Myerson: Good afternoon.

Pete Skibitski: Guys, maybe to start out, you know, 2022 is a pretty, pretty good growth year, weighted to the first half. Is something similar for 2023 reasonable for investors to expect, I don't know, in that 4 to 6% type of a range?

Yossi Gaspar: Hi Pete, this is Yossi. You know that we do not provide guidance. However, if you look at our backlog numbers that have grown significantly, much more than our revenue numbers, then from that, it is just natural that during ’23 we are going to be able to realize some of that growth in revenues as well.

Pete Skibitski: Right. Okay, fair, fair enough. Thank you for that. And then, maybe, Yossi, on the 62 million employee comp in 2022. Do you guys have the number for what that was in 2021, so we could judge the magnitude of the increase? And maybe factor in our expectation for ’23?

Kobi Kagan: Hi Pete, good morning, this is Kobi. Actually the 62 million dollars is the difference between the numbers that we reported between 2021 and 2022. So this is actually a one-time expense, which is higher in all totality than the numbers in 2021. And in addition, we had some, mostly for engineers, some retention related programs that cost us and additional one time of 10 million dollars.

Pete Skibitski: Okay. Okay.

Kobi Kagan: So it's 72 million dollars of additional expenses, that we are not expecting to have during 2023

Pete Skibitski: Right, okay. So I imagine there are people out there thinking that 2022 is probably a trough margin year for Elbit. And that given, you know, hopefully, the likelihood that employee linked comp will decline in ’23. And I don't know if there are other mix issues, or if net pricing has improved, but is it reasonable for us to expect margins to improve in ’23 by some amount? I don't know if you want to put any kind of a range around it or not, but I guess I'll stop there.

Yossi Gaspar: Again, Pete, we do not give you exact numbers. But definitely the numbers that Kobi mentioned earlier will not repeat themselves in ’23.

Pete Skibitski: Okay, okay. And then, Yossi, just on net pricing, in terms of base labor rates, are you guys able to cover the inflation from base labor rates in your pricing in 2023? Or are you expecting improvements or a deterioration of that situation? Can you add some color there?

Kobi Kagan: Well, you know, Pete that about, I would say 75% of our labor force is in Israel. The compensation of these people is done in local currency, of course, the Shekel. During 2022, we had currency exchange rate between the shekel and the US dollar of roughly about 3.3 shekels to the dollar. In general, on an average. This number is going to improve in 2023. It is still to be calculated, but we expect an improvement in this cost, the labor, in dollars.

Pete Skibitski: Okay, okay. No, I appreciate it. Okay, yeah, I'll stop there. Thanks so much, guys.

Kobi Kagan: Thank you Pete.

Operator: If there are any additional questions, please press star-one. If you wish to cancel your request, please press star-two. Please stand by while we poll for more questions.

The next question is from Atinc Ozkan of WOOD & Company. Please go ahead.

Atinc Ozkan: Thank you. Perfect pronunciation of my name. This is Atinc Ozkan from WOOD & Company. Sorry if my questions are repetitive. I was not able to join the earlier part of the conference. But two questions for you, please.

The first one is regarding your recent strategic MOU in Japan. You signed it with two local companies. And we know that Japan is rearming, and they will be spending roughly, I guess 300 billion dollars over the next five years. Where do you see the strategic opportunities for your products in Japan? Should we assume that you will start with the needs of Japanese air defense force, given

that they are an operator of F-15 and F-35? That's the first question.

And the second one is, could you please provide some updates regarding completion of your ongoing investment programs whether it's the One ERP, the ongoing production line in South Carolina, and the state of the art plant in Southern Israel for IMI? Thank you.

Butzi Machlis: It’s Butzi, hello. With regards to the first question, we all see that there is ongoing investment in Japan in defense. We find that our portfolio is very relevant to the growing needs in this market. We see there is a lot of interest in our portfolio, and I'm talking about training solutions, I am talking about avionics, I am talking about UAVs, and others. For that we have teamed with several companies in the country. As you noticed, we presented at the latest exhibition, two weeks back, and this is not the first time we are in this market. And we certainly see a growing opportunity in these areas as well as in others, in the Japanese market. It’s a new market for us. We feel very welcome in this market. And we have very good relationship with the local industry, and the customer, the Ministry of Defense that is well aware of our technologies and capabilities.

With regards to our new facilities, our new facility in the south in Ramat Beka will start operations during 2024. And we expect it to be fully operational in 2025. Our production facility in South Carolina will enter into production this year, 2023. And I think we talked about the One ERP system. We have invested a lot in our One ERP solution, the system that we are deploying right now, that will replace 11 different old ERP systems that were in use in the company. The final implementation stage will take place in the middle of this year, when we implement the system in the old IMI company's operations. And this will be the final implementation phase, the rest of the company is already on the system. And we expect to start seeing many benefits coming from coming from this new

ERP solution.

Atinc Ozkan: Crystal clear.

Butzi Machlis: Thank you, Atinc.

Operator: The next question is from Pete Skibitski of Alembic Global. Please go ahead.

Pete Skibitski: Yeah, thanks guys. Butzi, you talked about increasing defense budgets around the world and how you're spending, increased business development money to take advantage of those markets. And I think you were implying that R&D was a part of that, overall. And 2022, I think, you spent the most on R&D in probably a decade, and I know FX had an impact. But, going forward, should we expect that R&D spend will remain elevated, so that you can take advantage of these very active markets over the next few years? Or have we reached a plateau there? Just was wondering if you had any color to add.

Butzi Machlis: As you know, our strategy is to be a leader in the defense market. And for that we have to invest in R&D, We are investing in several areas, just to give you an examples, high power lasers. We have a unique position in this market, we have a unique technology, and we are providing the laser source for the Israeli lad based high power laser solution. And we are a prime contractor for the airborne Israeli high power laser. This is just one area where we invest.

Another area is guided munitions. After the acquisition of IMI, we took a strategic decision to combine our guidance capabilities with the munition portfolio of IMI. And today we have a new, very advanced, line of business, which is very successful in Israel as well as abroad.

Another area where we are investing quite a lot is autonomy. We see potential for autonomy in AI and big data in these areas. We believe we are a world leader, and we would like to continue this investment. This year, we invested about 7.9% in R&D, and percentage-wise I don't think we will increase the number in the future. So that's more or less the level where we will continue to invest in

the future as well.

Pete Skibitski: Okay, thanks so much.

Rami Myerson: Thanks, Pete.

Operator: There are no further questions at this time. Before I ask Mr. Machlis to go ahead with his closing statement, I would like to remind participants that a replay of this call will be available two hours after the conference ends. In the US, please call 1-888-782-4291. In Israel, please call 03-925-5900. And internationally, please call 972-3-925-5900. A replay of this call will also be available at the company's website, www.elbitsystems.com.

Mr. Machlis, would you like to make your concluding statement?

Butzi Machlis: I would like to thank all of our employees for their continued hard work and contribution to Elbit Systems' success. To everyone on the call, thank you for joining us today and for your continued support and interest in our company. Have a good day, and goodbye.

Operator: Thank you. This concludes the Elbit Systems Ltd. fourth quarter 2022 results conference call. Thank you for your participation. You may go ahead and disconnect.

[End of conference call.]

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